Introduction

The Central Bank will keep the króna within the target bands

After the Central Bank raised its policy rate by 0.8 percentage points on November 1, the monetary stance through interest rates became tighter than at any time since the present financial and monetary regime was established in the middle of the last decade. The stance tightened even further due to a drop in inflation and in inflation expectations. The short-term interest differential with abroad, on the other hand, has remained broadly unchanged. Towards the end of January, the Central Bank's real policy rate was just over 6½% based on the inflation premium on T-bonds, and the short-term interest rate differential with abroad (trade-weighted) was just under 6½%. Bank interest rates, however, remained unchanged since they were last raised in November.

Despite the increase in the Central Bank's policy rate, the downward trend of the exchange rate continued. At the end of January the króna was down by 3½% from the beginning of November. The slide of the króna in recent months may partly be explained by the fact that the cut in fishing quotas and poorer economic prospects implied a reduction in the equilibrium exchange rate. Nonetheless, the Central Bank considered it necessary, in the prevailing economic conditions, to counteract the downward trend. There are three main reasons. Firstly, the Central Bank was concerned that a lower nominal exchange rate would be likely to fuel inflation, given the overheating of the economy. Even though the real exchange rate might arguably be too high, an untimely adjustment had to be avoided. A decline in the exchange rate can only be compatible with low inflation if the economy has cooled down sufficiently. Secondly, the Central Bank does not view the level of the real exchange rate as the main cause of the large current account deficit. Further depreciation of the króna is therefore by no means inevitable. Thirdly, the Bank thought it necessary to avoid an excessively sharp drop in the nominal exchange rate, among other things because of the conceivable negative consequences for financial stability. It therefore intervened in the foreign exchange market in order to prevent such a development, which could have led to a greater temporary depreciation than is compatible with long-term balance.

Since the króna began to slide, the Central Bank has raised its interest rates and sold currency in order to defend the exchange rate. The last occasion when the Central Bank sold currency in the interbank market was towards the end of January. The Central Bank will use the instruments at its disposal in order to keep the króna within its fluctuation bands. Recently, the Bank made an agreement on an unconditional credit facility to the amount of 21½ b.kr. in order to boost its ability to defend the exchange rate, over and above its earlier provisions.

Inflation during the second half of last year was lower than had widely been expected. It slowed from an annual rate of around 6% in spring 2000 to 3½% at the beginning of this year, despite a considerable depreciation of the króna during the second half of 2000. The slowdown in inflation has not caused much change in the Central Bank's inflation forecast for this year. Consumer prices are forecast to rise by just over 4½% during the year, the same figure as forecast last November. The reason for not forecasting a continuing decline in inflation is that the impact of the weaker króna is eventually expected to be transmitted to prices. This impact will be felt more slowly than before, but will not disappear. The arguments for this are presented in the article on Economic and Monetary Developments and Prospects in this issue. Of course there is some uncertainty about this point. Conceivably, part of the depreciation will not be passed into prices, and the lag may also be longer

than assumed here. Inflation would then be lower than forecast for the coming months, but gain momentum later. An opposing factor is that strong excess demand in the goods and labour markets could contribute to higher inflation. Assuming that the exchange rate remains unchanged, the price outlook has improved somewhat since November, and an inflation rate of 2.7% is forecast from the beginning to the end of 2002, provided that the economy begins to cool during the course of this year.

In the Central Bank's view, for two main reasons there are still no grounds for easing the monetary policy stance. Firstly, as the following article argues more closely, no unequivocal signs have yet emerged that the economy is cooling. Secondly, under the present conditions, a lowering of the Bank's policy rate could conceivably further weaken the króna, taking it uncomfortably close to the lower limit of its fluctuation band.

As has already been made clear, the Central Bank considers that the present large current account deficit represents both a symptom of overheating in the economy and a risk to the stability of the exchange rate and financial system. The main task of economic policy at the moment is therefore to counter the overheating which is the reason for the deficit. Even though its main cause is not an overvalued real exchange rate, the consequences of the current account deficit could still be an untimely depreciation and an undesirably high rate of inflation. Sharp changes in the exchange rate, which often accompany an excessive current account deficit, could undermine financial stability. This, among other things, was the view of a mission from the International Monetary Fund which was published in January and is included in this issue of *Monetary Bulletin*.

To reiterate, the Central Bank does not consider the level of the real exchange rate to be the main cause of the current account deficit. The real exchange rate appreciated much less during the upswing which is now maturing than it generally has in previous upswings, and, following a considerable slide since last spring, it is now below its average over the last 20 years. To some extent the present large current account deficit is puzzling in light of the significant fiscal surplus. Its primary cause is probably to be found in the factors which have kindled demand growth and reduced the savings rate. Excessive credit growth, to a substantial extent funded with foreign borrowing, plays a large role in this development. If action is taken in the near and medium term to address the causes of the current account deficit by promoting greater national saving, reducing national expenditure, easing labour market pressures and dampening credit growth, a further drop in the exchange rate may well be avoided.

The statement of the IMF mission proposes that the current fluctuation bands of the exchange rate be abolished, that inflation targeting be adopted as the framework of monetary policy and full instrument independence given to the Central Bank for reaching the target. The Central Bank has been examining this option closely for some time and has included articles on inflation targeting in its publications. In the Bank's view, many arguments favour the adoption of inflation targeting. This would be a logical extension of the development towards greater exchange rate flexibility and a closer focus on price stability, which began in 1995 with the widening of the exchange rate fluctuation bands. No decision has been made about taking this step, which in any case would require some prior preparation. It must be underlined that if inflation targeting is adopted, the exchange rate would not necessarily head outside the present fluctuation bands. In an open economy, the exchange rate exerts a strong impact on prices. For this reason, monetary policy would still need to take exchange rate developments into account. Nor do conceivable reforms to the monetary policy framework alter the above assessment of the position of the exchange rate. Market participants therefore have full reason to treat the current exchange rate fluctuation bands as a reference point.

The Central Bank sees an unquestionable need for a tight monetary stance for the time being in order to contain inflation. Furthermore, the Bank also identifies a pressing need to dampen general demand to prevent the current account deficit from threatening both price and financial stability.